Episode 72: Variable Annuities. When they are useful as a retirement income planning option.

00:00
Bob French
The purpose of Retire With Style is to help you discover the retirement income plan that is right for you. The first step is to discover your retirement income personality. Start by going to Risaprofile.com/Style and sign up to take the industry's first financial personality tool for retirement planning. When you can stack your step ups, good things are happening. Trust me, it'll make sense after the podcast.

00:49
Wade Pfau
Hey, everyone. Welcome to retire with style. I'm Wade, and I'm here with Alex. Hey, Alex, good to have you on the show. Hello.

00:58
Alex Murguia
Hello. Thank you, Wade.

00:59
Wade Pfau
Thanks for having me for the podcast. Absolutely. And today we're going to do a mini arc within an arc. I think we're going to start talking about variable annuities. And we both started talking. At first it was just going to be one episode, but I think there's so much content that we can probably have two episodes on variable annuities. So we'll get started with it, see how far we get along, and then, as needed, pick up in a second episode on this. So think of this as part one of variable annuities. Are you excited, Alex?

01:29
Alex Murguia
Hey. Twice as nice. Most definitely. We're going through it and we realize even the last few episodes, it's just a big deal. Just the naming conventions and just understanding the definitions that it takes time to just digest that. I'm sure you had no problem with this weight, but it's like taking like high school geometry or something and you're just learning Isosceles and all these sort of terms. And you almost need to learn the

terms first before you can begin to apply them in calculations and the like. And I think there's a little scaffolding that we need to put in here as opposed to just creating a deluge of information.

02:10
Wade Pfau
Right? Yeah, fair enough. And that's going to be another issue as we start talking about variable annuities. And this came up at the alliance for Lifetime Income Summit. But it's something I've been thinking a long time. There's no standardization even with the terms, so we'll be using one set of terms in this. But we'll have to point out that these go by a lot of other names at different insurance companies, and it's just a matter of every company is looking for an edge in how they market the products they create. So there's no universal or standardized way to talk about any of this either. But we'll do the best we can to give everyone a good overview. And that does require introducing even more vocabulary into the conversation as well.

02:53
Alex Murguia
I think the cynic can say, oh, is the obfuscation done? So there's pricing advantages, sort of taking advantage of the consumer and the like. I mean, maybe there's some of that. I don't think someone gets in a room and decides, how are we going to confuse folks? But I do think what happens unlike, let's say, stocks or mutual funds is that these are all annuities are effectively individual contracts and individual contracts run by individual companies. And so they each have some Idiosyncratic workflow within their companies that different than others. There's no, like, stock exchange clearinghouse where you put a bid as bread, there's a price and things are bought or sold. It doesn't function like that. Remember, these are ultimately contracts. And so that just brings in a whole host of considerations that are specific to each firm, wouldn't you say? Wade, I think it has more to do with that than anything.

03:59
Wade Pfau
Yeah, and that's where, as well, it's just a matter of company A thinks a better term to use is X. Company Y thinks a better term to use a Z. There isn't standardization. But you're right. No central clearinghouse. It really is up to each company to develop the contract in the manner that they think is most appropriate.

04:22
Alex Murguia
And with that, we enter the land of elucidation. Right way.

04:27
Wade Pfau
That's right. So the episode is about variable annuities, but to be more precise, we're talking about deferred variable annuities, which flashback from previous episodes. What does that mean, alex oh, my goodness.

04:46
Alex Murguia
To Mary Beth and the Social Security quizzes. No, effectively, the term immediate income annuity. An income annuity. They're immediately annuitized. Right. So single premium immediate annuity. You're receiving the payments at that point, but it's been annuitized. A deferred income annuity. It's annuitized the moment you sign that contract, but you're just receiving the payments later. Here a deferred annuity with guaranteed living withdrawal benefits and the like. It has not been annuitized. And that's something that's very important. And this is actually my first time around. I remember this when I was studying this years ago, the first time around, and you start hearing this. It hit me afterwards like, oh, they're not annuitized. I get it now. It takes a while, especially as income comes in from the writer. So these deferred annuities follow the English convention of the word deferred annuities in the sense that they're not annuitized yet.

05:47
Alex Murguia
Did I pass?

05:48
Wade Pfau
That's right.

05:48
Alex Murguia
Did I pass, Wade.

05:49
Wade Pfau
Yes, you got it. And just as a note, there is something called an immediate variable annuity where you are annuitizing the contract. But they're so rare that we won't even really get into the discussion of them. And to be clear, what we are talking about is not immediate variable annuities, but deferred variable annuities where the decision to annuitize the contract is being deferred to potentially never happen. But if you have a guaranteed lifetime income benefit that enters the settlement phase because you have spent down the underlying asset base, then you could think of that as when the contract is annuitized as well.

06:26
Alex Murguia
Exactly. It's almost like in these manner, in these sort of contracts, they're annuitized when things have gone, when they're in the money, if you will, you'll get into that. I don't want to get ahead and go off on the topic. But I would say this. I know DPL does this survey of advisors and they ask them questions like this, and many advisors get this wrong. And so it's one of these weird things. It's almost like I think they study

for it to get their certifications and that's it. They move on to other things and it's forgotten with normal decay of things. So there you have it. Kind of an interesting nugget.

07:10
Wade Pfau
Yeah. And so to just be clear about, because we're talking about deferred variable annuities, these are not irrevocable decisions because annuitizing is what makes it irrevocable. You can have liquidity with a deferred variable annuity, you can access the underlying contract value. Most contracts would have some sort of free surrender where you can take a certain amount out before being hit by the surrender charges, which could exist in the early years of the contract if you want to take out more than the allowed amount. But if you're using this as a long term tool, which you should be doing, it's not meant to be a short term tool. You generally wouldn't have to worry about surrender charges and otherwise. The point is, these are liquid contracts. You can get your money back out of them. You're not annuitizing the contract. And in particular, in these episodes, when we talk about deferred variable annuities, we'll leave that RYLA conversation to the side.

08:08
Wade Pfau
We're not talking about registered index linked annuities yet. We're talking about the variable annuity with the sub accounts, where you're choosing investments, underlying, quote unquote, mutual funds. They're not technically called mutual funds, but it's the same idea for different stock asset classes, bond asset classes, whatever is available in the universe of options you have with that contract, you're choosing the sub accounts and you have a contract value. Now, that contract value, that's the first term we're hitting here, where different companies call it different things. It may also be called an account value. I think that's the other more common term, but I tend to use as a default contract value. It's the value of the underlying assets in the contract.

08:54
Alex Murguia
Wade, real quick, before we get into the down and dirty, it's relevant since we set it up a little bit in the previous episode. From a Risa perspective, from a retirement income style awareness perspective, what quadrant is this hitting?

09:11
Wade Pfau
We're at this point, really on the right hand side of the Risa matrix because it is the more probability based. You're going to choose sub accounts to focus on growing the assets. And then if you add a lifetime income benefit, it is very much the heart and soul of what the risk wrap strategy is trying to do give you exposure to market growth, but putting a guardrail around that so that you know you have protected lifetime income even if the markets don't cooperate and you end up spending down the underlying asset base. So risk wrap and the last point.

09:46
Alex Murguia
I would add to this because it goes with the first episode we did is because they're providing guardrails. You can't compare these apples to mutual fund expense ratios and we'll get into the expenses on these. But there's machinations that need to be done by the insurance companies to be able to provide these guardrails that they go under a line item but they're not comparable to just a mutual fund expense ratio. They're doing things to make sure that they can annuitize it if that time ever comes. So they can also though provide these guardrails for you along the way.

10:31
Wade Pfau
Right? Yeah, we will talk about fees because when you hear the idea that annuities have high fees out in the general like consumer media generally, that is specifically referring to variable annuities as being the quote unquote high fee type of annuity. So we will be talking about fees in our conversation but that'll be a little bit later. We got to get through all the mechanics first of what these are all about. You investing in sub accounts.

10:58
Alex Murguia
Open that hood. There we go.

11:01
Wade Pfau
And then if you're using it as an investment only variable annuity, the idea would be you're trying to achieve tax deferral, not looking for lifetime income but using it more as a tax play. But we're going to be mostly focused on the case where you do choose from an optional guaranteed lifetime withdrawal benefit. That is an optional writer that will have a fee or a charge as well, but that generates an allowed amount of income you're willing or distribution you're able to take each year you can take up to that distribution amount. And by doing so as you do that, if you ever deplete the underlying contract value, that triggers the guaranteed lifetime withdrawal benefit to enter a settlement phase where they will continue, the insurance company will continue to provide that. Payment amount on an ongoing basis for the rest of the life of the annuitant and or annuitants the individuals on whom the contract is defined in terms of their mortality.

12:07
Wade Pfau
So that's the idea that we want to dig into here. Now behaviorally and that's when we talk about the Risa, the retirement income style awareness. We talk about risk wrap as being more of a behavioral quadrant because at the end of the day you could achieve the same sort of outcome with a life only income annuity and stocks. But behaviorally it can be complicated to choose the life only income annuity where you do make that irrevocable decision. You're exposed to the quote unquote hit by a bus risk and then with your

investments being 100% stocks with what's left. That's also troubling for a lot of people even though they can justify through the risk capacity of knowing they have this protected income from the income annuity. But behaviorally, life only income annuities and stocks are rough. And so the deferred variable annuity with a guaranteed lifetime withdrawal benefit, which was really just developed in the 1990s, provides a behavioral way to get the same sort of outcome within one financial product so that as a deferred variable annuity, you have the contract value.

13:12
Wade Pfau
It's not an irreversible decision. You have technical liquidity. You can get the funds back now, just like a brokerage account. If you've allocated these funds to provide a lifetime income, you may not have the true liquidity because this is earmarked for your future spending, but you do have the technical liquidity just like in a brokerage account. And you're not sacrificing the asset with an irreversible decision. You still see the contract value as part of your statements in terms of what are the assets that you own. So it's no longer like with Social Security or an income annuity. You have this huge asset. It's just you don't see its value anywhere on any sort of financial statement. You can't see the contract value of the variable annuity on your financial statements if you with the protection, that may help you to feel more comfortable investing more aggressively.

14:03
Wade Pfau
And also behaviorally, with the protection in place, not only might you invest more aggressively, but if it gives you the comfort to stay the course and not panic after a market downturn, that's an additional benefit as well.

14:16
Alex Murguia
Wade, quick question here, and I'm going to go with a guarantee supports aggressive investing because I've heard you speak about it a bit, I think you've even referenced Moshe here a little bit. But some folks it's weird, but do you want these to go underwater quickly so you take advantage of the settlement period and annuitized or annuitize it because let's say it supports aggressive investing. You can get the upside and the like, but some folks are saying, heck, get one that it goes underwater quickly and then you can annuitize it, which you can't guess just the same. But you follow what I'm getting at from annuity standpoint.

14:55
Wade Pfau
And it's not so much that you want it to go underwater quickly in the sense that you want the markets to tank. Yes, if the markets tank, you'll be okay. But you don't specifically want that. You're all else the same. You'd like the markets to do well and to get growth and step up opportunities and maybe never outlive the contract value. But the important point there is an important point and if you're paying for this protection, you want to take advantage of it. And that means you want to take the allowed distribution amounts. If

you're not taking the full allowed distribution amounts that the guarantee provides, you're less likely to ever deplete the underlying assets and you're paying for insurance that you're less likely to ever need. So really the statement there that relates to what you are saying is take the distributions, the insurance companies will create different ideas that will encourage you to delay taking distributions.

15:48
Wade Pfau
And that's actually what we got to get into with some of the vocabulary about roll ups and so forth. But at the end of the day, the sooner you start taking the income, the more likely you are to benefit from the insurance. The more likely you are to deplete the underlying account through spending and therefore trigger the settlement phase where you have this protected lifetime income. The insurance company is on the hook to provide those payments.

16:14
Bob French
Are you a financial professional looking to learn more about the Risa and Retirement Income best practices? Well, if you are, you should join our retirement income masterclass on Monday, August 28 and Tuesday, August 29. You can sign up at risapprofile.com/advisors. That's Risaprofile.com. /Advisors.

16:35
Alex Murguia
All right, get your papers and pens out and start writing.

16:40
Wade Pfau
Yeah, that's where we now got to talk about. So we have the deferred variable annuity. You invest in sub accounts. Now we have to really explain what the Guaranteed Lifetime Withdrawal Benefit is all about, and that requires introducing some vocabulary. Now, one of the terms I'll use is benefit base, but this also goes by different names. It could be known as the income base. It could even be called the Phantom income base, although I don't think any insurance company does that. It would be more phantom would be someone just describing what it is. But what it is. The benefit base, the term I'll use, it's this hypothetical value that's used to calculate the guaranteed income. It's not a value that you have accessible. What you have accessible is the contract value of the assets in the annuity. But the benefit base could be more than the contract value.

17:35
Wade Pfau
It could have achieved new higher values, well above what the underlying contract value is. You don't have access to that. But that is used in the calculation with the Guaranteed Lifetime Withdrawal benefit to determine what your guaranteed distribution amount is. And that benefit base can grow for two different general reasons. The first is there could be a roll up rate. And a roll up rate is just some sort of fixed return

provided each term or each year generally, to grow the benefit base over time. It could be a simple or compounded return. There are some contracts that have a 10% simple return, which is just the benefit base will increase by 10% of the premium amount each year for a certain amount of time. Usually there's some sort of limitation on how long you get these roll ups for maybe ten years, or it may be up to a certain age.

18:35

Wade Pfau

But you got that idea, and that's where there's a lot of confusion. If I have a 10% simple roll up rate on my annuity, that would quickly and easily be misinterpreted as my money is growing at 10% a year. That's not what it means. And to be clear, usually your money grows with a compounded rate of return so that growth upon growth rather than just growth on the initial benefit base. But still, that's not what it means. This is just purely a hypothetical calculation to determine a benefit base. Your underlying contract value is not growing at the roll up rate. It could grow by the roll up rate, but that's a completely separate consideration. It depends on how the underlying sub accounts are performing. Okay. And then you also have step up opportunities. If the contract value grows to achieve a new high water mark, to actually have that contract value be worth more than the benefit base would be based on its roll ups, then you can reset the benefit base and usually only on whether it's annual, monthly, daily, annual is the most common or quarterly.

19:45

Wade Pfau

But on particular dates you check the value of the contract and if it's at a new high watermark level, you step up to that and the benefit base is reset to that new high watermark level. Okay. Now that being said, another issue is, does the contract provide stacking, which is really getting into the weeds. But it's important, if the contract has stacking and you achieve a new high water mark to step up the benefit base to a new high level, the roll up rate then applies to that new level rather than continue and apply to the initial premium. If there's no stacking, even though you have a new high water mark, the roll up rate continues to apply to the initial premium. So it may take a while for those roll ups to catch up to that new high watermark again. All else being the same stacking is a better thing than not having stacking because it gives you more opportunity for benefit based growth.

20:44

Wade Pfau

And then the final vocabulary term is just the guaranteed withdrawal rate. What's the payout schedule on this? Which is usually not gender based, but age based, and it's usually within age ranges. So there may be one payout rate for ages 60 to 64, another payout rate for ages 65 to 69, and so on and so forth. And if you're close to one of those borders where there's an increase in the payout rate, that's one of the few scenarios where Moshe Molesky suggests hold off defer on the start of the income. Otherwise generally the finding is start taking distributions as soon as possible. So that's the vocabulary, I think. Looks like your eyes are glazed over a little bit there.

21:28

Alex Murguia
Alex, did you no, I'm letting you speak. No, I mean, look, the reality is I want to add color, but it's like no, it'll ruin it more than help. So you're on a roll. But if I'm looking at it, if there's anything to add, since you said it is, just look at the interplay. If I'm telling the consumer something here, or the advisors even look at the interplay between these, right, the anchored all of this is the contract value. And then variability is introduced by the benefit base and the roll up base from that standpoint and then leads to step up opportunities and stacking. There's kind of an order of operations to these and try to understand them like that.

22:11
Wade Pfau
Yeah. And the roll up rate, if the contract has one, generally only applies during the phase before you start taking the lifetime distributions. The quote unquote deferral phase of the contract. It's a deferred annuity and it has a deferral phase. If you're waiting on taking distributions, the roll up rate would apply. Then the step up opportunities generally apply both during the deferral period and the distribution period. It's just once you start taking the guaranteed distributions, it's harder and harder over time to have step ups to new high watermarks because the contract has to still grow in value net of your distributions and fees, which may happen in the early years of the distributions, but over time becomes a bigger and bigger challenge to continue. So step ups would continue to increase the guaranteed income when they happen. So to your point about spending down the asset base no.

23:07
Wade Pfau
If the contract continues to grow in value, the insurance company may never be on the hook to pay you out of their pockets, but you could be getting step ups which support more and more guaranteed income over time.

23:19
Alex Murguia
You're talking about guarantees now. So in terms of living benefits, how do the guarantees grow during the deferral period?

23:27
Wade Pfau
Well, they grow by the roll up rate and or the step up. And actually we're talking about one, if there's a contract that has a roll up rate, we're talking about how that works. There's a completely different way that this could work that doesn't have any roll up rate or benefit base. But I'll save that discussion when we talk about fixed index annuities so we can talk about a different guaranteed lifetime withdrawal benefit there. For today's purposes, variable annuities would more commonly have roll ups with step up opportunities.

24:00
Alex Murguia
Another key issue, though, that someone may have missed, and you're kind of saying this, but just to put it out in a specific question, how are guaranteed withdrawals determined?

24:11
Wade Pfau
So they're determined by taking that payout rate factor, that age based payout rate. If it's four and a half percent, if it's 5%, if it's 6%, you take that and you multiply it by the benefit base and that tells you how much you're allowed to take out and still preserve the guarantee. So you're spending your own money, you're spending from the contract value, but if you don't exceed the allowed distribution amount, you're preserving the guarantee. So that if you ever did deplete the contract value, the guarantee kicks in and continues to pay that same promise.

24:47
Alex Murguia
And that's what you're paying all those expenses for, ultimately for the insurance company to manage that. And how does the flip side is how does the insurance company manage those risks?

24:59
Wade Pfau
Oh, that's a whole nother I think you're looking at a slide summarizing what's coming ahead. I don't know if we want to jump all the way to that right now. That's definitely a conversation that will have.

25:12
Alex Murguia
We talked about it a little bit in the first episode just in terms of how they have it investments and the insurance company has their own general account, if you will.

25:22
Wade Pfau
But you're right, yeah, that's fixed annuities. That's not variable annuities. There's no general account with these kind of variable annuities because it's more like a brokerage account. You're choosing subaccount investments on your own. But there are when you have a guaranteed lifetime withdrawal benefit, that does create risk for the insurance company. And so we can have a whole discussion around how they look to manage that risk. Let's just hold off for a few minutes on that one. But I guess in terms of what else we might need to mention here, we've talked about how the roll up rate is not a guaranteed rate of return. It just simply is used to calculate the value of the benefit base. We've talked about step ups and stacking. We

should probably mention I keep using the term guaranteed lifetime withdrawal benefit. That's another potential vocabulary point where different insurance companies may call that something different.

26:25
Wade Pfau
But there are different types of living benefits that are not guaranteed lifetime withdrawal benefits. So what I'm specifically talking about, a guaranteed lifetime withdrawal benefit supports a guaranteed lifetime income without annuitizing the contract. There are others. There's something called a guaranteed minimum income benefit that it would require you to annuitize the contract to get the lifetime income. Any annuity can be annuitized, but there's going to be a benefit base involved in this one, that hypothetical benefit base that if you can grow that benefit base when you annuitize the contract, you might get more spending than you would otherwise get from the contract value. So the guaranteed minimum income benefit just lets you annuitize and get an income based on the benefit base rather than the contract value. There's a guaranteed minimum accumulation benefit that's not related to lifetime income. It's simply providing a minimum growth rate for the underlying contract value.

27:27
Wade Pfau
And then there's a guaranteed minimum withdrawal amount benefit that's not lifetime. It's simply allowing you to withdraw a certain amount from the contract no matter how the market performs, whether it's ensuring that you at least get your premium back or if there is a benefit base, at least getting the full amount of the benefit base back, but not necessarily a lifetime income. So to loop back around again, it's the guaranteed lifetime withdrawal benefit is what's supporting the lifetime income got you. And that age based payout schedule is usually going to be lower than SPIAs or Diaz, the single premium median annuities or deferred income annuities. That's where the cost of liquidity and the ability for upside growth potential is reflected in the worst case market scenario you're going to get less income, but are you comfortable accepting less income in the worst case scenario, to have liquidity for the contract and the upside growth potential?

28:27
Alex Murguia
That's kind of why you want to back into that's kind of why you want to back into your essential expenses.

28:34
Wade Pfau
Right? And funding the essential expenses would generally cost more with a variable annuity. If you want to assume no step ups happen. But if you get the step ups, ultimately you can grow that guaranteed income over time. Another point we should discuss is and Moshe molevsky, I mean, he's done everything in retirement income, but he had a great article about insurance companies giving you the temperature in Celsius when all you understand is Fahrenheit. And what he meant by that. He is Canadian, so he would get the Celsius. But I think he was writing that for the American audience that would only understand the

Fahrenheit. Right, but what he was getting at is Fahrenheit is what's the guaranteed income? How much am I going to get from this glwb benefit Celsius is I obscure what that guaranteed income is because I don't tell you what it is directly.

29:35
Wade Pfau
Instead, I hide it between, okay, we've got roll up rates and we got withdrawal rates. I could create a huge roll up rate and then just apply a low withdrawal rate to it, and you wouldn't necessarily get more guaranteed income out of the contract. But if you're just the salient factor for you is the roll up rate. And that's where if you're thinking, oh, I'm getting a 10% guaranteed return on my money. No, you're just getting a 10% roll up rate. But then if I gave you a below typical withdrawal rate to apply to that, it's not more income. Just an example of that. Suppose we're going to get a variable annuity, we're going to defer for ten years. We'll put $100,000 into a variable annuity, and we'll defer for ten years. And then we'll take income. We'll assume we didn't get any step ups.

30:25
Wade Pfau
We're just going to use the roll up rate. Suppose contract A has a simple 10% roll up rate, and at the age we're going to start distribution I need.

30:36
Alex Murguia
To stop you right there because it's the simple versus compound.

30:42
Wade Pfau
Yeah, simple is the roll up rate only applies to the initial premium. You don't get the growth on growth. So in this case, a 10% simple roll up rate on $100,000 premium, every year the benefit base increases by $10,000. Whereas if that was 10% compounded, the benefit base would grow by $10,000 in the first year, but in the second year it would be 10% of now $110,000 or $11,000. And then in the year after that, it's now 10% of $121,000 or like $12,100 and so on. You get a much faster growth over time with a compounded roll up rate.

31:30
Alex Murguia
Sorry, Wade, I just want to do that because I think sometimes it's. Easy to forget that.

31:34
Bob French

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32:00
Wade Pfau
Yeah, so 10% simple, ten year deferral, four and a half percent distribution rate, that would provide me $9,000 of guaranteed income, but if I'm just focused on, oh, the 10% roll up rate, it may sound really great. Now compare that to another contract that, let's say, has a six and a half percent compounded roll up rate for ten years, and then instead of a four and a half percent withdrawal rate, it has a 5% withdrawal rate. Which do you think sounds better? 10% simple roll up rate with four and a half percent withdrawals, or a six and a half percent compounded roll up rate with a 5% withdrawal rate? Do you have a preference there?

32:44
Alex Murguia
Oh, you're asking me? Really?

32:46
Wade Pfau
Yeah. This is the problem, though. You've got to do the calculation.

32:50
Alex Murguia
Yeah. Quickly you would naturally. You see your ten, you see something with two digits, and you're like, wow, give me some of that. But obviously it's a loaded question. It's the second one. And not only that, it's a six and a half percent compounded. So even if the distributions maybe were the same level, it'd be interesting to see the math. All that ends up being because the compounded versus a 10% simple alone could put it over the top. But continue.

33:15
Wade Pfau
Right. So for a ten year deferral, six and a half percent compounded roll up, 5% withdrawal, that's $9,386 of guaranteed income. That's $386 more than the 10% simple and four and a half percent withdrawal. So that's this idea of Fahrenheit versus Celsius people understand what's the guaranteed income but that gets obscured in these multi step calculations you have to do by applying the roll up rate and then applying the withdrawal rate to it. And that, I hope, also further illustrates the idea that I could give you a 20% roll up

rate. But if I attach that to a very low withdrawal rate, it doesn't help you. You're not going to get more guaranteed income necessary.

33:59
Alex Murguia
So the reality is the consumer needs to kind of, on an Excel spreadsheet, look at both of those variables, not just one of them.

34:06
Wade Pfau
Right. And then the answer does also. We were assuming a ten year deferral for this calculation, but if you're going to only defer for five years, or you're going to defer for more than ten years, although at some point most of the contracts will shut off the roll up rate at some point around ten years.

34:24
Alex Murguia
But going back to the roll up.

34:26
Wade Pfau
Sorry, no, I mean, just you have to do the calculation for your scenario to see what income will be in the worst case scenario, which is just only looking at roll ups, ignoring the idea that there could be step up opportunities as well.

34:42
Alex Murguia
And when usually are the roll ups vested?

34:47
Wade Pfau
They're usually vested on the anniversaries of the or where this becomes an issue. Usually they're vested annually. And so the simple version we're talking about as well. We're generally just looking at annual opportunities for step ups or roll ups. But there may be some contracts where you could have even a daily roll up rate. It's just those roll ups don't get vested until the end of the year. That's where the vesting issue can come into play, that you may get a daily roll up. It's just if you decide after 364 days to start your guaranteed income, those daily roll ups wouldn't have been vested until you got to the 365th date. So if you wait another day, you get much higher income. Okay. And then the other you want to know that term in the money, which is just if the contract value is less than the benefit base, then the contract is more valuable all

else being the same, because the potential guaranteed income as a percentage of the contract value would be higher.

35:53
Wade Pfau
And that's where if you have a legacy annuity, you've got some annuity that you purchased years ago, it's possible maybe you should have never bought that. Maybe you were sold it at a chicken dinner seminar that we talked about before. But that being said, looking at it today, if the contract value is much less than the benefit base, there may be no better option out there. This relative to where you are today, it could be a good deal for you. Maybe you should have never entered into it, but that doesn't mean you should give it up as soon as you learn this. Yeah, when the contract send the money, it makes it valuable.

36:26
Alex Murguia
What you're saying is the market machinations have happened that you can't get that type of benefit in the open market anymore, and you happen to sure you wouldn't have gotten it to begin with, but chance has worked in your favor and is giving you effectively a mispriced contract, right. If it was to be sold right now.

36:47
Wade Pfau
Right, because the benefit base is higher, if I exchange that contract value into a new annuity, I'd have to reset the whole process of building a benefit base. And given where I'm at with the benefit base on this contract being higher than the contract value, it may be from this point a decent deal. Maybe it wasn't the best idea.

37:07
Alex Murguia
I think this is an important point because I think even at McClain or sometimes folks come in with annuities and let's say there's an advisor that's a fee only advisor or something like that, looks at this and automatically they want to flip out of that. They want to do something to sort of just blow it up because philosophically, they don't believe in annuities or whatnot. I think it's a vibra. It's not just, yeah, let's get out of this and move on. It could actually happen to be a very good option for that person because of this mispricing.

37:44
Wade Pfau
And then another point is just on the death benefit side, the standard death benefit is usually the contract value is the death benefit. If there's still money in the contract, that's the death benefit. You can also add optional death benefit writers, which would give you more of a super sized death benefit. One example might be as long as there's at least $1 in the contract, you'll get the whole initial premium returned as a

death benefit. So that can be an interesting option for someone who doesn't really need income. And maybe this is in a retirement account where there's going to be required minimum distributions. So you can fund those required minimum distributions, but still protect the initial value of that through this optional death benefit as long as $1 remains in the contract. You just have to be careful because now the death benefits usually require money to remain in the contract.

38:40
Wade Pfau
So you don't want to have an optional living benefit and an optional death benefit on the same contract because of the optional living benefit. You only ever receive any true benefit if you deplete the contract value, but then that would sacrifice the death benefit. So they're not compatible with each other. And we didn't spend much time talking about death benefits, but just it's important to be aware that's out there and it's another potential use of a variable annuity when you don't need the income. Maybe you're not going to be eligible for getting a new life insurance policy, but you want something. So optional death benefits could be worth looking at in those types of scenarios as well.

39:19
Alex Murguia
Okay, and Wade, you had said it, I'll let you talk about it a little bit more because even myself, the language can get crazy. Like the roll up, stack on step ups. Just the alliteration alone is like whoa kind of thing. If you do get a step up, do the roll ups have to catch up to the step up or are they stacked upon it? Can you just talk about that a little bit? You mentioned it earlier. But again, I think these are one of these dynamics that it just merits making it crystal clear as possible.

39:56
Wade Pfau
Yeah, the stacking thing is interesting because I know of at least one company that has the stacking, but they don't even market it, even though it's such a great benefit. And so I was wondering, why don't they market this? Because if you don't have stacking, the step ups and the roll ups are kept separate. So the roll ups continue on the initial premium for as long as until you turn on income. And then the step ups, if you got a new high watermark, you reset the benefit base to that level. But now the roll ups aren't doing anything until they catch up because they're.

40:30
Alex Murguia
Below the benefit base. Remember, they're taking below the benefit paths.

40:34
Wade Pfau
Just wanted to yes, independent paths. Whereas if you do have stacking, what that means is if you got the

step up so your benefit base is higher than where the roll ups would have gotten it. Now you reset and you start applying the roll ups to that new high watermark benefit base. So that can be valuable. It can support higher income depending on the sequence of returns experienced. But there's value there all else being the same. And the other point to just mention in this episode as well, we have covered it, but to remind everyone, and this is often used as a quote unquote gotcha against the annuity, but that's not really what it is. You are spending your own money. You're spending on the contract value. And sometimes that's used to say, oh, the annuity doesn't do anything, you're just spending your own money.

41:29
Wade Pfau
But no, you're paying for the protection that in the process of spending down your own money. It ever causes the account to deplete. If you're using the 4% rule and your account depletes, you're out of luck. You can't spend anything else. If you have the variable annuity and your account depletes, that's triggering you've paid for this insurance, that triggers, okay, the guaranteed income that you had, the withdrawal rate times the benefit base, that spending amount continues. You continue to receive that payment for the rest of your life even after spending down the contract value. So that's what's happening and that's a valuable benefit.

42:10
Alex Murguia
That's another point that I see. And I see this sometimes where sort of the gotcha kind of thing where someone comes in with actually a variable annuity with living benefits and it's fine, it's actually a fine contract from the standpoint of insurance and the like. And someone's been paying, let's say 15 years on this thing and all of a sudden they change advisors for whatever reason. And the knee advisor just says, hey, we're out of here, we're out of there, we're going to blow this up. And sometimes because they say, look how expensive this fee is. But they're not taking into account that no, it's expensive because you've been paying insurance and not only that, you've been paying it for 15 years already. And then all of a sudden now in the moment of truth, when it's getting closer to the moment of truth, you're going to just walk away.

42:54
Alex Murguia
It's one of those that I find it always like, I'm always remiss when something like that happens.

43:01
Wade Pfau
Yeah, and that could be a sunk cost where it doesn't really matter that you've been paying for 15 years. But what does matter is if that contract is in the money, it could be negligent to sacrifice the contract because you just don't like variable annuities or whatever the case may be. That's where you have to be very careful when you're looking at these older contracts that someone may have and evaluating whether it's worthwhile to keep them.

43:25
Alex Murguia
So Wade, I just succumbed to the sunk cost policy?

43:28
Wade Pfau
That's right. Yeah.

43:36
Alex Murguia
Come hella high water, I'm going to force the issue.

43:43
Wade Pfau
But as you did earlier in the episode mentioned about how does the insurance company manage the risks and that's such a big topic that I think it could be a good cliffhanger that maybe we'll not try to make this episode super lengthy, but we'll come back in the next episode and talk about the risk management and then go through a series of questions and factors. That to help summarize what we've been talking about. Things you want. To know about the annuity contract. And if you're trying to understand how the variable annuity works what all you want to make sure you do understand for that. And so we'll save that for a separate second episode on variable annuities. That sound good to you there?

44:23
Alex Murguia
Do I have a choice?

44:27
Wade Pfau
You're just along for the ride.

44:28
Alex Murguia
Yeah, I'm just happy to be here. No, most definitely. All right, everyone, we'll catch you next week, or, as we say, between Wade and I, in about five minutes.

44:41
Wade Pfau
Part two. Part two on variable annuities coming up.

44:44
Alex Murguia
Coming up.

44:46
Wade Pfau
Thanks for listening.

44:47
Bob French
Wade and Alex are both principals of McClean Asset Management and Retirement Researcher. Both are SEC registered investment advisors located in Tysons, Virginia. The opinions expressed in this program are for general informational and educational purposes only and are not intended to provide specific advice or recommendations for any individual or on any specific securities. To determine which investments may be appropriate for you, consult your financial advisor. All investing comes with a risk, including risk of loss. Past performance does not guarantee future results.